

BLUE STAR LIMITED
ANNUAL REPORT 2000-2001



C O R P O R A T E V I S I O N

To deliver
a world-class
customer
experience



BLUE STAR

BOARD OF DIRECTORS

Ashok M Advani
Chairman & Chief Executive

Suneel M Advani
President & Vice Chairman

T G S Babu
Executive Director

Bal K Malhotra
Executive Director

Atul C Choksey

Uday Kotak

G Ramchandani

Minoo R Shroff

Suresh N Talwar

COMPANY SECRETARY

K P T Kutty

BANKERS

The Hongkong & Shanghai Banking Corporation Ltd
Standard Chartered Grindlays Bank Ltd
State Bank of India
Oriental Bank of Commerce
ABN - AMRO Bank
BNP Paribas
Bank of Baroda
Abu Dhabi Commercial Bank Ltd

AUDITORS

K S Aiyar & Company, Mumbai

BRANCH AUDITORS

R Venkatarama Aiyar & Company, Kolkata
Fraser & Ross, Chennai
Mohinder Puri & Company, New Delhi

REGISTRARS & SHARE TRANSFER AGENTS

Intime Spectrum Registry Pvt Ltd
260, Shanti Industrial Estate
Sarojini Naidu Road, Mulund (West), Mumbai 400 080
Telephone: 91-22-592 3837
Fax: 91-22-567 2693

REGISTERED OFFICE

Kasturi Buildings
Mohan T Advani Chowk
Jamshedji Tata Road
Mumbai 400 020
Telephone: 91-22-202 0868
Fax: 91-22-202 5813
www.bluestarindia.com

CORPORATE MANAGEMENT

Ashok M Advani
Chairman & Chief Executive

Suneel M Advani
President & Vice Chairman

T G S Babu
Executive Director

Bal K Malhotra
Executive Director

Satish Jamdar
Executive Vice President

H N Ganatra
Vice President - International

V V Inamdar
Vice President - Western Region & Industrial Division

Arun Khorana
Vice President - Electronics Division

Ranajit Majumdar
Vice President - Human Resources & Quality

Avinash Pandit
Vice President - Packaged Airconditioning Division

A S Prakash Rao
Vice President - Northern Region

H Rajaram
Vice President - Finance

S Sankaran
Vice President - Southern Region

Neeraj Seth
Vice President - Commercial Equipment Division

N Sivasankaran
Vice President - ACPD Marketing & Service

BLUE STAR LIMITED

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LETTER FROM THE CHAIRMAN



Dear Shareholder,

The year 2000-01 was Blue Star's first full year of operation after the demerger of the software business. It is a matter of considerable satisfaction for me that the encouraging financial results for the year have vindicated my optimism about the Company's bright future even without the software business.

After three consecutive years of slow growth, coupled with the demerger of the software business and discontinuance of the industrial projects activity, the biggest challenge facing Blue Star in 2000-01 was to accelerate revenue growth. Accordingly, each of the business units developed new growth strategies which were largely achieved in spite of a slow economy and intense price competition. Total Income grew by 15% under these difficult conditions, and we were able to enhance market share while increasing Profit After Tax by 55%. These are all achievements of which the entire Blue Star team is very proud.

How did we achieve these results? To be candid, there was no magic formula for success. It required a combination of intelligent strategy, executed by a capable and committed organisation keeping costs under control while squeezing higher productivity out of all resources - financial, human and factory capacity.

Let me explain how these factors came together last year to produce the big improvement in the Company's performance. Before I start, I should clarify that for comparative purposes, all figures I refer to pertaining to last year exclude the software business.

CORPORATE VISION AND FOCUS ON THE CUSTOMER

Our Corporate Vision is to deliver a world-class customer experience. This is a refinement of our earlier vision of providing world-class engineering products and services.

Blue Star is now focused on its core businesses - airconditioning and refrigeration, as well as marketing of professional electronics and industrial equipment. These involve more than merely supplying a product; a high degree of customer interaction and engineering support is also a vital requirement.

Customers now take for granted the availability of good quality products at competitive prices. To win their business, we must offer something extra which can broadly be defined as a good 'customer experience'. We try very hard to be sensitive to customer expectations and feelings, because these subjective factors have a major influence on their buying decision. A transaction with the customer is viewed on an end-to-end basis, right from the time we receive an enquiry, to how quickly we respond, the quality of our quotation, the follow-up with the customer all the way through booking and executing the order, handing over, and even thereafter, during warranty and after-sales service.

While the Company may not have reached world-class in all respects, a number of programmes have been initiated to address issues of concern to customers. To give you a few examples of what customers care about - hassle-free telephone

access, spare parts availability, quality of service manpower and ensuring safety at project sites. Some of these may sound mundane, but the cumulative effect of many improvements over a period of time is quite significant.

BRAND EQUITY

About three years ago, we did some market research to assess what people thought about Blue Star. We got some interesting and useful feedback. We were happy to hear that the Company evoked a positive image in many people's minds, especially those of corporate and institutional customers. There were some significant strengths in the Blue Star brand, such as acknowledged expertise in the central airconditioning business, concern for the customer, financial stability and a reputation for dependability. In short, we were seen as 'customer-focused professionals.'

But with individuals and smaller businesses who are mainly buyers of window airconditioners (WACs) & mini split airconditioners (mSACs), the position was different. There were many big players in the low end of the airconditioner market supported by high advertising outlays. Blue Star just did not have the same visibility and top-of-mind recall as the other players in these segments. This gap in the Blue Star brand image was a concern to us. But it also provided a major business opportunity to tap a large, under-exploited customer segment.

We therefore decided to broaden the Blue Star brand appeal and extend it to the WAC and mSAC market. This was done through a long-term marketing and high visibility advertising plan which involved a substantial investment over a three-year period. This brand equity programme has now achieved its broad objectives and is coming to a close. There has been a positive shift in brand perception and recall.

We began to see some results last year, when a spate of innovative new products was introduced, supported by higher product advertising expenditure. These were reinforced by the greater visibility and positive image of the brand which led to gains in market share in the WAC and mSAC segment, as well as in the central airconditioning business. We expect to continue to reap the benefits of brand equity building in the current year and beyond.

HUMAN RESOURCES

As I had indicated earlier, corporate success is not merely a matter of formulating a good business strategy; it also requires effective execution of plans. And this is where the people of the organisation come into the picture.

Managing people is often referred to as the 'soft' side of business. But in many respects, it is very hard. We human beings are complex creatures, and behavioural scientists have many theories on human resource management. Blue Star's approach is more pragmatic. We have evolved certain human resource practices over the years through experimentation and innovation, and have learnt from practical experience what works for us. The Company has a number of ongoing organisational initiatives. We are:

- ◆ Investing increasingly in employee training to improve skills, change attitudes and behaviour, and develop better managers.
- ◆ Flattening the organisational structure and pushing more responsibility down the line to speed up decision making.
- ◆ Linking rewards to performance.
- ◆ Streamlining processes and simplifying the work flow.
- ◆ Shifting the work culture towards activities which create value.

More details are provided in the Management Discussion and Analysis Section of the Annual Report. For our purpose, suffice it to say that, while building organisational capability is a long, painstaking process, last year we saw definite benefits appearing from greater investments in this area. The encouraging business performance was largely due to the smooth working of a confident, motivated and productive organisation.

COSTS, EXPENSES AND RESOURCES

In our very competitive business, tight cost control is essential for long-term survival. Blue Star's continuing efforts in this area have been substantially responsible for the steadily improving profitability.

Last year, market prices were under severe competitive pressure. The decline in selling prices was largely offset by corresponding cost reductions which virtually maintained the corporate gross margin at 26%, the same as the previous

year. Value engineering, more effective procurement and outsourcing of non-critical activities, all contributed substantially.

While revenues grew by 15%, the increase in total expenses over the previous year was limited to only 7.5%. Manpower productivity improved significantly with employee expenses declining from 10.7% of Total Income to 9.9%.

There was also better control of inventories and debtors. The focus on working capital management permitted a reduction of Rs 6.69 crores in borrowings leading to a decline of 6.5% in interest costs.

On the whole, much hard work on managing costs and expenses, making productive use of resources and efficient tax planning yielded an impressive improvement in Profit After Tax.

SHAREHOLDER VALUE

The equity markets are in a confused and uncertain state. The long stock market boom in the United States ended with the bursting of the dotcom bubble in early 2000, leading to a sharp decline in share prices, especially in technology stocks. These developments were mirrored on the Indian bourses. Local valuations which had been driven to unsustainable levels, collapsed. Many small investors lost heavily, and their confidence has been seriously affected.

Being part of the 'old economy', Blue Star was outside the mainstream of speculative stock market activity. The share price languished in the Rs 30-40 price range and briefly dropped sharply at the height of the stock market scandal in March 2001, before recovering to its earlier level after perceptive analysts realized that the historical dividend provided a very attractive tax-free yield.

A major reason for this disappointing performance was the compulsory rolling settlement imposed by the stock exchange on a trial basis in early 2000 on a small number of listed companies which unfortunately included Blue Star. Because of this, trading volumes and liquidity in our shares virtually dried up. SEBI is now introducing a number of market reforms and extending compulsory rolling settlement to all companies. Hopefully, these steps will improve trading practices and bring about a much needed revival of the stock market.

While the stock market has yet to recover, savvy investors are once again beginning to look at corporate equity values

in terms of fundamentals such as sustained growth, profitability, cash flow and dividends. Equally important is the track record and credibility of the management.

It seems that the wheel has turned full circle. The questions facing Blue Star and its shareholders are:

1. What is a fair valuation of our Share?
2. What needs to be done to bring the price up to this level?

Let me address these issues:

1) What is a fair valuation of Blue Star shares?

Whatever financial experts and analysts may preach about sophisticated financial valuation techniques, there is no reliable way to value a particular share. Besides looking at financial performance, valuation involves a number of external elements with the business environment, investor sentiment and the state of the stock market all playing a major role.

Blue Star has historically been a low profile company as far as the stock market is concerned. We have felt that the primary responsibility of Management is to focus on the business and deliver good financial results. We have believed that if the Company performed well, the market would recognize and reward the investors by suitably boosting the share price.

Has this happened? The attached Annexure shows the last two years' financial results along with some typical ratios and performance measures commonly used to evaluate companies. Most financial analysts would agree that these figures are respectable. Yet it is clear that the stock market has not acknowledged our fundamentally good performance. For various reasons the Blue Star share has not been given the valuation it deserves.

The current share price of around Rs 45 is less than book value and reflects a low price/earnings multiple of about 4. Moreover, the tax-free dividend yield is more than 12% which is very attractive at a time when interest rates have come down substantially and there are few safe, high-income options. Such is the prevailing situation.

2) What needs to be done?

In retrospect, I must admit that we held an overly simplistic view of the stock market. While delivering good financial performance is necessary, it is not sufficient to attract and reward shareholders. We also need to create investor interest

in Blue Star by becoming more market friendly and by improving the investor perception of Blue Star. Here are some of the steps that we are taking:

a) Better Corporate Governance, Transparency & Disclosure

Recent amendments to the Companies Act and the Listing Agreement with the Stock Exchange, Mumbai have introduced additional requirements for companies and their boards regarding corporate governance. Interestingly, for several years, Blue Star has been voluntarily complying with a number of these requirements such as independent directors and disclosure of additional market information.

The law lays down time limits for complying with various aspects of corporate governance. We have taken this responsibility seriously and have not waited for the deadlines. A number of changes have already been introduced ahead of time. For instance, we have already formed an Audit Committee and Shareholder Grievance Committee. Another major change is the new Management Discussion and Analysis section of this Annual Report which provides a wealth of information on business segmentwise performance.

Transparency and disclosure form a fundamental plank of effective corporate governance. To us this is not merely a legal requirement; I firmly believe that voluntary action which goes beyond what the law stipulates makes good business sense. It can only benefit the Company and its stakeholders in the long run.

b) Better Corporate Communications with the Outside World

Blue Star is a good marketing company when it comes to its products and services. Considerable corporate resources and energy are devoted to this vital function. But we have not done an equally good job of marketing the Company to investors. The perception of Blue Star held by investors, the financial community and the broader public is sometimes hazy, unfocused and often uninformed. This is unfortunate since it means that Blue Star is not always the company of choice for investors. This perception problem must be rectified if the Company is to find its rightful place in the equity market.

An important need is to improve corporate communications with the media, the stock markets, financial analysts and brokers and, of course, our shareholders. A start was made

last year with the Press by releasing much more news about significant corporate developments. This year, the capital markets will also be provided additional financially relevant information on a more frequent basis.

In short, a combination of good financial performance, better corporate governance, greater transparency and more effective corporate communications should do much to improve the valuation of Blue Star's shares. We are doing what is in our control.

But, in the final analysis, we are still highly dependent on the business environment, Government economic policies, a healthy stock market and that very nebulous factor called investor sentiment. Hopefully, these will become more positive soon.

ASHOK M ADVANI

Chairman & Chief Executive

Mumbai

June 22, 2001

ANNEXURE TO LETTER FROM THE CHAIRMAN

BLUE STAR FINANCIAL PERFORMANCE (EXCLUDING SOFTWARE BUSINESS)

	2000-01	(Rs crores) 1999-2000
Total Income	509.82	443.80
Growth over Previous Year	+15%	
Profit Before Interest & Taxes	34.26	26.39
Profit Before Tax	25.57	17.10
Growth over Previous Year	+50%	
Profit After Tax	23.54	15.14
Growth over Previous Year	+55%	
Shareholders' Funds (excluding Revaluation Reserve)	110.04	98.81
Borrowings	57.35	64.04
Capital Employed	167.39	162.85

KEY RATIOS

Gross Margin	25.9%	26.1%
Operating Margin	6.7%	5.9%
Return on Capital Employed	20.47%	16.21%
Return on Shareholders' Funds	21.39%	15.32%
Earnings Per Share	Rs 11.58	Rs 7.45
Dividend Per Share	Rs 5.50	Rs 5.00
Capital Turnover	3.05	2.73
Debt/Equity	0.52	0.65
Inventory Turnover	6.01	5.10
Receivables (Days Billings Outstanding)	58	60

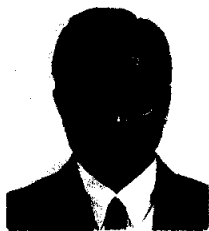
BOARD OF DIRECTORS



Ashok M Advani



Suneel M Advani



T G S Babu



Bal K Malhotra



Atul C Choksey



Uday Kotak



G Ramchandani



Minoo R Shroff



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